FOREIGN CAPITAL IN DEVELOPING ECONOMIES

May 1959

Approved For Release 1999/08/24 : CIA-RDP78-02771R000500140003-6

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Introduction

This paper presents the opinions of economists on the use of foreign capital in developing economies, the effects of private foreign investment in a few countries selected as case examples, and the attitudes of governments toward the use of foreign capital.

These attitudes have always been widely divergent, varying from warm acceptance to rejection. Some countries have tended to view foreign capital as a liability rather than an advantage. They have sought to achieve economic balance entirely within their own system through taxation, land reform, nationalization, cooperatives and other similar measures. These may undoubtedly prove beneficial in many respects, but it appears to be generally accepted that the injection of foreign capital is a powerful stimulant which cannot be rejected without detriment to the economic welfare of the country in question.

The dual economic problem of raising the per capita income of some areas plus the maintenance of a rate of growth in others has been given serious attention by governments and international organizations. Studies by the United Nations Department of Economic and Social Affairs, the International Bank of Reconstruction and Development (IBRD), the International Monetary Fund, the Export-Import Bank and economic committees of the Organization of American States all testify to the widespread need for increasing amounts of capital to ensure the development of economies.

Their conclusions note that most nations, even those with high per capita incomes, must seek some part of their capital from outside sources. Widespread agreement on the desirability of expanding the flow of international private capital is reflected in the resolutions of the UN General Assembly and of its Economic and Social Council.

Although many believe that foreign capital will flow into their economies, if permitted, this cannot happen because there is not enough capital in the world today to meet the demand. Even countries with a high per capita income such as Canada and Australia are in the market for foreign capital with which to sustain the growth and balance of their economic systems.

The most painstaking analyses of underdeveloped economies agree on the point that private foreign investment has been inadequate and considerably less than hoped for since the end of the war.

One noted economist, Benjamin Higgins of the Center for International Studies at Harvard University, has summed up the problem thus:

> "Far from being a matter of 'permitting' foreign capital to come in under restrictive conditions, it is a matter of competing for capital against other countries, including highly developed ones as well as other less developed countries."

It appears paradoxical, therefore, that some countries not only do not actively bid for foreign capital but even impede the flow of such capital into their economic systems. This can be explained, however, by the fact that the role of private foreign capital within sovereign states has not been clearly understood and this engenders fears, however misplaced, of foreign domination and exploitation. Thus, many nations, although realizing the need for modernizing their economies and increasing their per capita production, become the victims of a problem of their own making. While they recognize the need for capital which cannot be raised from domestic sources, they simultaneously resist the introduction of foreign capital because they fear foreign domination and exploitation.

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A. Foreign Investment in Latin America

Latin America provides an interesting illustration of the role played by foreign private capital in economic development.

Europe was the main source of foreign capital for many of the lesser developed economies of the world during the 19th century. In Latin America in 1913 private British investment amounted to 3.4 billion dollars, while French investment contributed 1.1 billion and the United States, 1.2 billion, aside from lesser amounts from several other European countries. This capital inflow made it possible to develop mines, plantations, railroads and public utilities. Foreign capital opened up natural resources which otherwise would have remained dormant, and brought foreign exchange into the countries through the export of products.

Latin American countries, however, have large import needs which the export of foreign holdings could not balance. The result was a recurrent balance of payment deficits. Foreign investors were all too easily blamed for this plight and from time to time charged with exploiting various Latin American countries. It is true that the total foreign holdings in Latin American were a mixed blessing. While those which produced exports brought needed foreign exchange into the economies, foreign investments in utilities took currency out of the country. If the foreign holdings in railroads and utilities had stimulated local industry to produce commodities otherwise imported, the story would have been different. But they did not do this. They supplied domestic services which did not supplant imports and therefore took some currency out of the local economies in the form of dividends to service the investments. As a result, instead of recognizing the basic problem, which was the need to balance the economy through production for domestic needs, the emotions of the country were channeled into resentment against all foreign holdings. Dispossession of the foreigner was seen as the simple answer to distressing economic conditions.

In addition, Europeans had been persuaded during the 19th century to put large sums of money into Latin American bonds. Because the use of this officially borrowed money had not been soundly planned for productive purposes, there was either a very small economic return on the investments or none at all. Interest payments were often defaulted by the governments and settlement on matured bonds tended to be far below the original value. As confidence in these governments and economies dwindled, European capital was redirected to opportunities for investment elsewhere.

Between 1914 and 1929, the United States assumed the role of principle investor in Latin America and at the end of that period American private investment amounted to 2.2 billion dollars in agriculture, mining and petroleum; .9 billion in public utilities and transportation; and over .2 billion in manufacturing. These enterprises proved relatively successful for the investor and contributed to the development of Latin American economies. In the field of government bond investments, however, American experience later repeated the European. Latin American governments defaulted their payments on some 64 percent of the bonds held and the market value of a $1,000 bond in 1939 was $309. The settlements on Latin American bonds finally agreed upon were in general far below the original investment.

The policy of Latin American governments toward foreign enterprises during the 1920's was generally favorable. Unrestricted entry of foreign capital was the rule, full convertibility of currencies prevailed and foreign business was not subject to any special regime. Changes occurred in the 1930's, partly brought about by the depression, which were not attractive to foreign investors generally. In addition to the defaults on bond interest payments and the repatriation of external debts at low market prices, the most important measure affecting business investments was the introduction of exchange controls which hampered the convertibility of currencies for foreign investors. Other measures in the 1930's such as licensing imports, limiting the expansion of investments in specified industries, tightening restrictions on the entry of foreign nationals for employment and expropriation caused further concern for foreign business in Latin America. A summary by Raymond Mikesell in Foreign Investments in Latin America, published by the Organization of American States, stated that:

> "At the end of 1939 total foreign investment in Latin America was one billion dollars less than it was in 1914; Latin America's private credit was ruined (although it had always been restored in the past after a few decades), and as a consequence of defaults, currency controls, expropriation and government restrictions, US private investors were generally sour on investing in the area...."

As a result, Latin American countries were faced with the problem of insufficient capital to finance the expensive task of developing their resources and balancing their economies.

United States direct investments in Latin America remained almost unchanged between 1936 and 1943. Between 1943 and 1950, however, American direct investments increased by about 70 percent to a total of 4.7 billion dollars. By the end of 1953 the value of such investments reached 6 billion dollars, representing an average annual increase of 400 million dollars between 1947 and 1952, and continued to climb unsteadily in the next several years. There was almost a complete absence of private capital going into Latin American government bonds during and after World War II. The sources of capital for public needs became institutions such as the Export-Import Bank and the IBRD.

The flow of private direct investment into Latin America after World War II reflects new confidence in foreign investors, although the total was disappointingly small to economists who realized the amount of capital required to achieve the minimum increase in productivity. They concluded that "the improvement of conditions conducive to a flow of private capital and the restoration of confidence on the part of investors will be at best a slow process." It was observed that the modest net increase in private capital inflow could be accelerated only if special action was taken to induce such a flow. Generally, the average earnings on US foreign investments are no more than 2 or 3 percent higher than similar investments in the US "in spite of the additional risk of doing business abroad." Investors could not be expected to sustain artificially induced risks over and above normal business risks.

The latitude for foreign capital in Latin America has been evaluated in a United Nations Economic Survey of Latin America 1956. In mid-1950, domestic savings accounted for 94 percent of the total investment in these countries. This investment, however, increased by only 2 percent in 1956 over 1955, which was less than the rate of population growth. Private capital investment, however, increased at the same time by 70 percent, the principal recipients being Brazil, Mexico, Peru and Venezuela. Domestic capital is enough to sustain the present per capita production in Latin America, but not enough to increase it. The countries must avail themselves of foreign capital if they are to provide the balanced expansion essential to their economies. Mexico, Peru and Venezuela have recognized this for more than a decade and have encouraged foreign investment.

Even minimum increases in output per capita cannot take place without increases in investment per capita. Studies vary in their conclusions as to the precise amount of capital investment required annually to raise production by a modest 2 percent a year (i.e. enough to keep up with population growth at its minimum). The lowest figures given by a 1951 United Nations study for Latin America are as follows: a total of 2.54 billion dollars a year would be required, of which .55 billion would have to be obtained from foreign sources, that is to say, the balance between the need and the amount that could be met from domestic sources. In a 1954 study, however, the IBRD places the annual investment need between 3.5 to 4 billion dollars, with the gap to be filled by foreign investment placed at 2 billion annually. Other studies since then generally agree that the amount of foreign capital needed annually to increase production by 2 percent is around 2 billion dollars. The foreign money flowing into Latin America since the war has been far below this.

B. Examples of Results of Foreign Private Investment

The practical results of foreign private investment in the following countries illustrate its contribution in developing economies.

1. Liberia

Liberia's basic agricultural industry, rubber, was developed by foreign companies. In addition to being the largest taxpayer--American rubber firms pay close to 40 percent of government revenues--these companies have provided the largest portion of the country's exports and imports. They produce more than 77 percent of the country's exports and bring in 35-40 percent of her imports, leaving the country a good balance of foreign exchange to meet other import needs. They have served as the pace setter in raising wages, increasing consumption levels and health standards and stimulating efficiency. In one year the companies raised wages by 20 percent, a figure that was considered reasonable and safe by responsible government leaders concerned with the effect of such a rise on indigenous enterprises and inflation. These companies proved that responsible private enterprise brings benefits to the country to such a degree that the government has consistently invited other foreign investment to participate in expanding the economy.

2. Mexico

Mexico's 40-year effort to transform her feudal economy into a progressive one was affected by foreign investment. After the adoption of the 1917 Constitution, many well-meaning administrations and also some corrupt leaders who bled the country for their own gain, moved too quickly and without sound economic plans in their haste to bring prosperity and social justice to their country. They expropriated foreign holdings, deprived foreign investors of their legitimate voice in the management of enterprises and launched land redistribution programs. Economic problems followed some of these actions. Foreign capital was frightened away by the extremity of some of the measures. Enterprises which had been integrated with international economic activities were cut adrift. Foreign markets refused to accept products from enterprises expropriated through unjust measures. Even the re-distribution of large land holdings failed to bring about the hoped-for increase in agricultural production. What land did pass into the hands of peasants (much of it was taken by politicians and their followers), generally was not effectively used. The techniques, materials and equipment needed for tilling the land productively were not in the hands of the peasants and much of the land required large-scale operations which could not be applied to the new smaller parcels. By 1940 the corn yield in Mexico was only 7.8 bushels per acre, compared to a yield of 28.4 bushels in the United States. In 1948, a leading Mexican agriculturist said there were "sixteen million hungry Mexicans" because the crop yields were so poor.

World War II gave an impetus to the Mexican economy and, equally important, re-established relations of mutual respect between Mexico and her war-time allies. Confidence was restored in Mexico as a responsible sovereign nation and economic relations were resumed on a business-like basis of mutual advantage. Foreign capital again flowed into the country. Agriculture was revived through the technical aid which accompanied the investment of foreign capital and by 1952 corn production was sufficient even to provide a small export surplus. The potential for other crops was equally good. Industry was bolstered and expanded by foreign funds put into capital-forming enterprises and manufacturing received much needed attention.

3. <u>Chile</u>

Some years ago Chile, severely handicapped by the lack of capital required to develop her natural resources, made strenuous efforts to encourage private local and foreign business expansion. The foreign business which responded developed a number of basic facilities which made it possible for local enterprises to get a start and also attracted additional foreign capital. Harbor facilities, overland roads and trucking lines, essential to get products to their markets, were built and used by all in open competition. Pioneering work in paper manufacture brought new producers into the field and this development was repeated in the textile industry. The original foreign enterprises no longer rank first in the production of many commodities, including sugar processing. They stimulated the development of local enterprises which were able to build upon the facilities and markets created through the exploratory work, risk-taking and capital improvement of foreign enterprises.

4. Foreign Banana Investments in Latin America

Foreign holdings and investments in Latin American banana producing countries deserve particular attention because it is improbable that this source of income would have been developed to the same extent without them. The land utilized by these companies was created from swamp and jungle--land that otherwise would have remained unproductive. Further, the development of banana crops is extremely costly and risky, and requires closely integrated operations from planting to marketing. An investment of $1,000 to $1,250 an acre is necessary to cover irrigation, spraying and other costs. The incidence of disease is high and the soil is quickly depleted, necessitating large surplus holdings to shift crops to new acreage. The crop is perishable and requires quick transportation and sure markets if it is not to be lost after harvesting.

Foreign banana holdings contribute about 95 percent of their total revenue to the national economies in some six Latin American countries. In regard to foreign exchange, some 70 percent of their total export sales is retained in the national economies, the balance remaining after the imports required to produce the crops are paid for.

Foreign banana holdings have consistently contributed more to the economies of these countries than locally-owned agricultural enterprises of all types. They produce 2 to 12 times as much per acre, and 2 to 9 times as much per man employed as local agricultural ventures--a considerably higher productivity which has been accompanied by a regularly increasing return to the countries. Measured against other export crops, the productivity per acre is from 1 and 3/4 to 5 and 1/2 times higher than locally financed crops such as coffee and cacao. In terms of government revenues the situation again shows a higher return from foreign holdings. The taxes paid compose a substantially greater percent of the government's revenue than the companies share in the national income. In two of these countries some 10 percent of the governmental revenue comes from the major foreign agricultural holdings.

The annual value added to the economies of the six countries in 1954 and 1955 amounted to 139 million dollars broken down as follows: 56 million in wages; 18 million in taxes and other payments to governments; 27.6 million in goods and services purchased locally and 36.6 million in imported goods and equipment. In addition to the income flowing into the countries from the annual exports, every year sees a substantial influx of new money for capital development. Foreign private investment has brought these countries an economic gain that they would not have possessed without it and they have produced more, acre for acre and worker for worker, than locally financed enterprises.

Controversy arose in Guatemala (one of the major banana producing countries) over foreign holdings a few years ago. There was political and social unrest in the 1940's because an ultra-conservative government had not always met the needs of the people and had granted privileges to favored groups, mainly indigenous, but also foreign. These national problems were aggravated when the next government proved too weak to withstand Communist pressures or to control Communist actions for so-called reforms. Professional agitators inflamed public opinion, played upon the real or fancied grievances of farm workers and demanded expropriation of foreign land holdings.

Thoughtful citizens found it futile to point out that foreign companies had contributed substantially to the economy and the general welfare of the country and were paying wages that were three times higher than locally owned plantations. Offers of the companies to meet with government officials to adjust contracts were ignored. The record of the companies, their willingness to pay reasonable prices and taxes and to receive fair returns were drowned out in the organized clamor against bigness, monopolies and foreigners. The Agrarian Law of 1952 was used by Communist-controlled offices for purposes it was never intended. Among other things, 234,000 acres of company lands on the Pacific coast were expropriated (leaving only 61,000 for cultivation) and 174,000 were taken on the Atlantic coast. The loss of the surplus land needed for the regular shifting of banana plantations and the fact that bananas had been the second highest producer of export revenue for the country, give some indication of what this expropriation cost the country.

C. Maximizing Contributions of Foreign Capital

In general, countries in which there are foreign holdings are concerned with two major questions. The first is whether foreign investments make a contribution to the economy that would not otherwise be realized and that they compare favorably with the contribution of locally financed activities. The second is whether foreign holdings create balance of payment difficulties.

In regard to the first question, the findings support the conclusion that foreign investment can contribute substantially to the general economic improvement of the economy. A study prepared for the Organization of American States for example reports that:

"Royalties and taxes take a substantial portion of the gross earnings of the export type investments. Petroleum is generally on a 50-50 profit-sharing basis with the local government. Local income taxes, to say nothing of other taxes and fees, accounted for $251 million out of the $505 million in net earnings...before taxes of United States-owned corporations and branches operating in Latin America in 1950. In Venezuela 50% of governmental revenue is derived from the petroleum industries and nearly 40% of governmental revenues in 1951 were devoted to investment purposes.

" Not only are the underdeveloped countries receiving a larger share of the gross earnings from foreign investment but the foreign investors are contributing directly to development in areas other than the export industries. Expenditures of foreign companies on transportation, power, water systems, harbors, and airports have provided services for the rest of the economy as well as the operations of the foreign companies themselves....conditions favorable to industrialization are developed....

" ...The export industries usually pay higher wages because productivity of labor is higher in these fields....

" It may be concluded therefore that while foreign investment in the export industries is always beneficial to an underdeveloped country, there are measures to be taken by both the foreign investor and the host country which help to maximize that contribution."

Some of the measures noted pertain to training and utilizing skilled workers and managerial personnel from the local community, financing local industries to supply materials and services to the domestic market as well as to the export producing industry, and similar moves to integrate more fully the foreign investment with the rest of the economy.

In regard to the second question, foreign holdings affect a country's balance of payments only indirectly through service charges (i.e. payment to investors for the use of their capital) and profits which take currency out of the country. The real question is the relationship of total import needs to capability to pay for imports, determined by the amount of a country's exports. Where foreign holdings are in export products, or domestic products which would otherwise be imported, there is a real contribution to the country. In addition to the foreign exchange gained or saved through these enterprises, upwards of 50 percent of foreign company profits (which might flow out of the country) are reinvested in the economy of the country.

A report on US Investments in the Latin American Economy by the US Department of Commerce shows that in 1955 US investments in Latin America produced 2.8 billion dollars worth of goods and services used domestically, and 2.1 billion dollars worth of exports which brought foreign exchange into Latin America. Production by US companies provided 30 percent of all Latin American exports. To produce these goods and services US companies employed 625,000 men (only 1.5% of whom were foreigners), and spent 4.3 billion dollars in Latin America for wages, salaries, materials, supplies and dividends. The profit remittances reached a figure only one-half as large as the taxes paid in Latin America and represented less than 12 percent of the gross sales revenue.

In Argentina in 1955 the over-all payments by US companies were 530 million dollars which accounted for a substantial share of the total income flowing into the country (or taking the place of goods that would otherwise have been imported). A breakdown of this figure shows that approximately 100 million went for taxes, 120 million for wages, and 280 million for locally produced materials. Some 79,000 workers were employed (only 200 of whom came from the US) by the enterprises involved. Between 1946 and 1955 250 million dollars of retained earnings were reinvested in Argentina to which another 200 million was added for direct investment.

D. Attitudes Toward Foreign Capital

The prevailing attitude of governments in the 1950's recognizes the need for and the advantages of foreign capital. Canada and Australia, among the highest per capita income countries in the world, are actively seeking foreign capital. Australia, for example, according to a special survey in the New Commonwealth (September 1958) is concentrating on the development of a more balanced economy to decrease its dependence on raw material export markets. Restrictions placed upon imports to protect infant industries have caused branches of foreign enterprises to be established in the country, and the foreign investment climate has been favorably influenced since 1955 by removal of the threat of socialization of industry and banking.

In Puerto Rico, the government is seeking to attract foreign enterprises through guarantees of favorable conditions. Also in Asia, the Japanese Ministry of Finance, in A Guide to Investment in Japan, cites the regulations pertaining to guarantees of foreign investment and remittances in an open bid for foreign capital. The foreword states:

> "Japan's natural resources are limited...(but the) energy (of the Japanese people) must flow into commodities for sale abroad if ever they are to become prosperous and self-supporting. But they cannot produce efficiently without proper access to raw material, without adequate facilities and without sufficient money to carry them along.
>
> "...(the Japanese) are desirous of obtaining help from abroad.... (of interesting) foreign investors in their capabilities.
>
> "This publication...is primarily intended as an official guidebook for foreigners who would venture to invest in Japan and profit from the vast potential that remains to be harnessed."

Rasim Cemani in his book Foreign Capital Investments in Turkey enumerates the laws governing the entrance of foreign capital and foreign business practice in a bid for investment. He notes that Turkey, during the early days of the Republic in 1923, considered foreign holdings anti-nationalistic and systematically purchased all foreign business. The economic outlook after World War II, he goes on to state, changed with the realization that low per capita income could not furnish the savings necessary to develop the resources of the country.

In 1950 a law was passed to guarantee foreign investment and was followed by other legislation to eliminate certain inequities. In 1953 foreign investment was still too low to meet the economic needs of the country and a committee was appointed to inquire into the causes. The general conclusions, which led to the New Law of 1954, held that the uncertainty of treatment of foreign business, e.g. taxes, transfer of ownership, financial policies, etc., caused foreigners to refuse to risk their capital. As a result of this report the President of Turkey said:

> "The economic equipping of our country has come to such a state that we now feel a great need for foreign capital and for the cooperation of foreign capital and technical knowledge."

The Prime Minister added:

> "...foreign capital will be unconditionally accepted where it will help the economic development of the country, but both the return of the foreign capital itself and the profits accrued shall have been guaranteed."

The laws passed seek to protect Turkish money and business and foreign capital equally. They entail no monopoly or privilege and no hardship, for either.

In Latin America the modest increase of private foreign capital has been stimulated by the natural resources needed to supply the requirements of expanding industrial centers in other countries and by opportunities offered in the regions' new markets. The Economic Survey of Latin America, published by the United Nations in 1957, adds that:

> "These, however, are not the only factors which account for the greater activity displayed by foreign investors in Latin America. An outstanding example is to be found in the efforts to encourage foreign investment made by a group of Latin American countries in recent years."

In Brazil, for example, federal acts granted foreign capital the same treatment accorded to domestic capital, and a little later (1955) an arrangement was made whereby imports could be effected without the use of foreign exchange. These incentives produced results: in 1956 the receipt of private long-term capital reached a level more than 40 percent higher than that in 1955, one of the most intensive rates of growth recorded in Latin America.

Although Chilean progress was less impressive, the inflow of private long-term capital (greater in 1956 than 1955) followed the enactment of taxation and exchange privileges aimed at attracting the foreign capital needed to explore and develop facilities for copper mining. Vast sums of money and long periods of time are required to develop many natural resources—and both of these features involve considerable economic risk which must be cushioned by equitable treatment. It took nine years, for example, in prospecting and building mining installations to bring the manganese mines in Amapá into production.

In Argentina economic policy after World War II discouraged foreign investment. Reform introduced in 1952 did little to modify the situation created up to that time, but in 1956 it was felt that the inflow of private capital would increase fairly considerably. The establishment of a free exchange market at the end of 1955 and the decision to unblock profits for transfer abroad were both incentives to foreign investors. But the inflow of private capital in 1956 was well below the figures of other Latin American countries and the climate in Argentina for foreign investment still needed time to develop.

Venezuelan concessions for liquid fuel extraction to European and United States enterprises in 1956 brought an increased flow of capital into Latin America. Division of profits was increasingly favorable to the country and there were favorable repercussions on Venezuelan balance of payments. Negotiations between other Latin American countries and foreign enterprises, with similar mutual advantages, are reported in other economic surveys.

E. Role of Foreign Capital Recognized

Studies on the use of foreign capital in the development of economies conclude that "most countries which have achieved a high stage of development have done so with the aid of foreign capital." Contrary to government loans (the only means of financing some types of economic endeavor) which require repayment, countries need concern themselves only with the carrying charges on private investment. In the words of a Pan American Union publication, "If the foreign investment has earned the cost of its hire, the real income of the community should expand by more than the service charges; (and) a net increment of real income [should be left in the country]."

There is apparently no question that foreign investment can earn more than the cost of its hire or that its contribution to the economy of the country can be maximized by the following means: integrating it with the rest of the economy to stimulate the development of local sources of materials and services, and processing raw materials both for home use and export.

But the necessary increased flow of foreign capital, which is subject to the same control as that exercised over domestic capital, can only be attained if the confidence of the investor is restored through favorable experience assisted by a clear and equitable definition of the legal status of foreign enterprises. The point has been stressed further that it is not capital alone which is advantageous to underdeveloped economies, but the entrepreneurial ability, technical skill and modern methods of plant organization and distribution that come with it.

In view of the many factors which have combined to reduce the incentive to invest abroad, many official and semi-official reports give attention to measures which governments can take to attract foreign capital. A report by the United Nations Economic Council for Asia and the Far East (ECAFE) can be summarized into the following requirements: legitimate guarantees, equitable treatment and opportunities with local investment, and stability. Other studies, many of them official publications seeking to attract capital, list the laws governing foreign exchange, taxes and entry and practices of foreign business, and otherwise provide the investor with information about the treatment he may expect.

Many studies recognize the two-sided problem of financing underdeveloped (low per capita income) areas—the investor's fear he will lose his money and the country's fear it will in the long run suffer disadvantages, if not outright exploitation. In the words of one of these studies, "foreign investment in a sovereign country, with its own company law, tax law, monetary legislation, foreign exchange control, etc., is a totally different thing from investment in colonies by citizens of a colonial power." But a sense of social responsibility, in addition to enlightened self-interest concerned with developing larger consumer markets in native populations, has also changed the nature of foreign investment in colonial areas.